# Utah Tax Review Commission

## May 11, 2007

## Subsection 59-12-104.5 (4)

## Criteria for Reviewing Sales and Use Tax Exemptions

(4) The Utah Tax Review Commission shall for each sales and use tax exemption the Utah Tax Review Commission reviews make a report to the governor and the Revenue and Taxation Interim Committee:

(a) on or before the November interim meeting in the year in which the Utah Tax Review Commission reviews the sales and use tax exemption;

(b) including:

(i) a review of the cost of the sales and use tax exemption;

(ii) a review of the following criteria for granting or extending incentives for businesses:

(A) whether the business is willing to make a substantial capital investment in the state indicating that it will be a long-term member of the community in which the business is or will be located;

(B) whether the business brings new dollars into the state, which generally means the business must export goods or services outside of the state, not just recirculate existing dollars;

(C) subject to Subsection (5), whether the business pays higher than average wages in the area in which the business is or will be located, increasing the state's overall household income;

(D) whether the same incentives offered to a new business locating in the state from another state are available to existing in-state businesses so as not to discriminate against the in-state businesses; and

(E) whether the incentives clearly produce a positive return on investment as determined by state economic modeling formulas;

(iii) a determination of whether the sales and use tax exemption is consistent with the Legislature's sales and use tax policy positions adopted in 1990 General Session H.J.R. 32;

(iv) a review of the purpose of the sales and use tax exemption;

(v) a review of the effectiveness of the sales and use tax exemption; and

(vi) a review of the benefits of the sales and use tax exemption to the state;

(c) recommending whether the sales and use tax exemption should be:

(i) continued;

(ii) modified; or
(iii) repealed; and

(d) reviewing any other issue the Utah Tax Review Commission determines to study.

(5) For purposes of Subsection (4)(b)(ii)(C), in determining whether a business pays higher than average wages in the area in which the business is or will be located, the Utah Tax Review Commission may not include wages of the following in making average wage calculations:

(a) wages of school district employees;
(b) wages of county, city, or town employees;
(c) wages of state employees; or
(d) wages of federal government employees.

TAX RECODIFICATION COMMISSION

SALES AND USE TAX POLICY

1990

GENERAL SESSION

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H. J. R. No. 32

By Franklin W. Knowlton

Ted D. Lewis

A JOINT RESOLUTION OF THE LEGISLATURE ADOPTING THE POLICY GUIDELINES ESTABLISHED BY THE TAX RECODIFICATION COMMISSION REGARDING SALES AND USE TAX.

Be it resolved by the Legislature of the state of Utah:

WHEREAS the Tax Recodification Commission has been studying the tax structure of the state of Utah since 1984;

WHEREAS the Tax Recodification Commission has culminated its study by adopting tax policy statements regarding each of the major taxes -- income, sales, and property;

WHEREAS the sales and use tax is the principal state tax used for general purpose funding, and changes in sales and use tax policy should be considered carefully; and

WHEREAS the sales and use tax policy statement of the Tax Recodification Commission is an excellent guide for lawmakers in reviewing sales and use tax policy:

NOW, THEREFORE, BE IT RESOLVED that the Legislature adopt the sales and use tax policy positions of the Tax Recodification Commission, which are as follows:

Position 1: The sales tax should be broadly based.

It is the position of the TRC that the state should seek a broad sales tax base. This position involves two general areas of analysis: (a) the definition of the general sales tax base; and (b) specific exemptions from that base. By taking the position that a broad tax base is desirable, the TRC is not making any prejudgments on the relative merits of any exclusion or exemption, but only that each exclusion and exemption should be analyzed and justified.

Position 1A: The sales tax base should reflect the overall economy.

It is the position of the TRC that the sales tax base grow with the overall economy and therefore minimize rates and rate increases. To accomplish this objective, the sales tax base must accurately reflect the general economy. The sales tax base should also seek horizontal equity by subjecting similar activities to taxation. As a framework for policy analysis, the sales tax base should presume taxability.

Position 1B: Sales tax exemptions and exclusions should be carefully scrutinized.

It is the position of the TRC that all exemptions and exclusions should be carefully scrutinized. The TRC recommends that the Legislature establish objective standards to evaluate current exemptions, exclusions, and future exemption and exclusion requests. (The TRC has developed proposed standards which the Legislature may wish to consider). It is also the position of the TRC that many exemptions, particularly those of a narrower scope, include a "sunset" provision. Where possible, the TRC encourages the use of credits or refunds in lieu of a general exemption.

Lastly, the TRC recommends that a reliable method be developed to evaluate and monitor the fiscal impact of each exemption and exclusion.

While the TRC generally cautions against the use of exemptions, all exemptions do not have common impacts on the sales tax base. For purposes of analysis, the TRC has divided the current sales tax exemptions into the following categories:

(1) Taxation and economic efficiency -- Exemptions in this area generally reflect the following: (a) a broad policy objective, such as the avoidance of tax pyramiding; (b) the existence of an alternative tax, such as motor and special fuels tax; (c) avoidance of inter and intra governmental taxation; or (d) a recognition that the costs of collection and enforcement outweigh any potential revenue gain. Exemptions in this category may in fact enhance the basic fairness of the overall sales tax system. However, periodic review of these exemptions is still warranted as some exemptions initially established in the name of economic efficiency may not now be necessary.

(2) Societal Objectives -- Exemptions in this area have primarily been enacted as encouragement for socially useful objectives. In addition, some of these exemptions offset to a degree the inherent regressivity of the sales tax. Periodic review is warranted to ensure that the objectives behind the exemption are still valid and the scope of the exemption is limited to intended beneficiaries. Many of these exemptions have existed since the inception of the sales tax but have not been critically reviewed.

(3) Economic development -- Most of these exemptions have been enacted in the past 15 years and reflect the premise that taxation incentives foster improved economic performance. Many were initially enacted to benefit a particular industry, although actual application may be broader than the original intended beneficiary. The use of credits and refunds may be more effective in targeting desired economic objectives. "Sunset" provisions are particularly applicable to these type of exemptions. Policymakers need to carefully distinguish between taxation efficiency exemptions and exemptions which are often of a more narrow scope and application.

Position 2: The sales tax base should seek to mitigate regressive impacts.

The sales tax is inherently regressive. While elimination of all regressive characteristics is neither practical nor in all cases desirable, efforts should be made to mitigate the regressive sales tax impacts. The structure of other taxes should also be considered in analyzing the sales tax impact.

Position 3: The sales and use tax should be administratively simple.

The laws governing the sales and use tax should be as simple and straightforward as possible. Efforts should be made to minimize the administrative impact on businesses, consumers, and tax administrators. This objective is particularly true in interpreting and complying with sales tax exemptions and exclusions.

Position 4: The sales and use tax laws should promote compliance.

Sales and use tax revenues should be viewed as funds held in trust for the people of the state of Utah. As such, sales tax collection laws and procedures should facilitate the expeditious remittance of these funds to the respective governments while minimizing the burden on the tax collector. Efforts should be made to simplify filing and reporting procedures.

Position 5: The sales and use tax should not be earmarked.

The sales and use tax is a consumption tax and is not related directly to any particular governmental goods and services. It therefore should be generally available for any appropriate governmental use and not earmarked for any particular service.

# TAX RECODIFICATION COMMISSION

## POLICY STATEMENT

## TAX EXEMPTIONS

Adopted September 15, 1987

The Tax Recodification Commission recommends that state tax policy be so structured to include a broad tax base. Using the following criteria, new and existing tax exemptions should require a preponderance of evidence that their advantages outweigh the value of a broad base:

1. The exemption is required by the U.S. or Utah Constitutions, federal statute, or federal case law.

2. The exemption saves more money in reduced administrative costs than is lost in reduced revenues.

3. The exemption improves the fairness of the tax burden.

4. The revenue impact of the exemption is small, given the benefits it provides.

5. The exemption is simple to understand and administer.

6. The exemption makes the tax laws easier to understand.

7. The exemption removes double taxation.

8. The exemption promotes good and definite social or economic policy and is cost effective when compared to alternative ways to support good policy.

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CRITERIA
SALES TAX EXEMPTIONS
SALES AND USE TAXES TASK FORCE

1. Is the exemption required by the U.S. Constitution, federal statute, or federal case law?

2. Would the state lose federal funds if the exemption were repealed?

3. Is the exemption required by the Utah Constitution?

4. Does the exemption exist because the cost of collecting the tax exceeds its yield?

5. Some exemptions may improve the equity of the tax system. Does the granting of this exemption improve the fairness of the burden?

6. Policy makers can choose between a tax expenditure and a direct expenditure to grant special treatment to certain classes of taxpayers. Given that a special class of taxpayers is deserving of special treatment, is the exemption the most efficient method to grant that treatment?

7. Does the exemption have a low cost?

8. Does the exemption increase progressivity of the tax system?

9. Is the exemption simple to understand? The granting of some exemptions can be so complex that the taxpayer is not certain whether he is entitled to the exemption.

10. Does the exemption remove double taxation?

11. Does the exemption promote economic development by encouraging outside firms to locate here and by helping Utah companies remain competitive?

12. Does this exemption promote a social policy adopted by the legislature? Exemptions are sometimes granted to certain classes of taxpayers and on some commodities needed to sustain life. Examples include religious and charitable organizations, medicine, and environmental improvements.

13. Does the exemption help a certain industry remain competitive?

14. A temporary exemption is sometimes granted to an infant industry or in response to a short term problem. Does the exemption fill an existing temporary need?

15. Does the exemption have "goodwill" benefit only? Some exemptions are difficult to repeal because they are gestures of goodwill or have always existed.

16. Is the original purpose for granting the exemption still valid and does the exemption still accomplish its original purpose?

17. Is the amount of tax revenue generated by repealing the exemption greater than the economic benefit (additional jobs, wages, purchases, etc.) that the exemption produces?

their sales and deduct the tax they have paid on the purchases. At the national level the VAT offers significant advantages over the retail tax: revenue is collected at a series of steps rather than entirely from the retail seller; an audit trail is facilitated,[26] and double taxation arising from application of tax to production inputs and to final products is avoided. The value-added tax can exclude all production inputs, which the retail tax cannot feasibly do, thus having fewer adverse effects on real investment and efficiency in production than a retail sales tax.

Problems in the use of the tax at the state level, however, are serious. Michigan uses a partial value-added tax element in its business tax, with firms calculating value-added, but the levy is by no means a true value-added tax. Louisiana has long used a value-added element in the state sales tax, but of limited scope. The basic problem is the interstate one; the most effective form, the tax credit (invoice) method, could function if all states used the tax with the same rate and coverage, and accepted the principle of sharing the tax on the final sale with states of location of the previous stages. But attainment of this requirement is most unlikely. A switch to a value-added levy to replace the state sales taxes would be feasible only if the federal government imposed such a tax and the states integrated their taxes into it. Such a shift is occurring to a limited extent in Canada, but many problems remain.

## *CRITERIA FOR OPTIMAL RETAIL SALES TAX*

In framing sales tax structures, the states, especially in earlier years, tended to regard a sales tax as simply a means of raising substantial sums of money. But, obviously, other considerations must play a role in the design of a sales tax structure if the tax is to meet the usual requirements of an optimal tax—avoidance of undesired economic effects, equity in terms of usual standards of the society, compliance and administrative effectiveness, and stability and growth of revenue. In terms of these usual standards, the following criteria can be established:

1. As the tax is designed to be a consumption-related levy:
   a. It should apply to all consumption expenditures, and thus to all sales for consumption purposes, at a uniform rate.[27] Failure to do so will distort relative outputs of various goods and services, discriminate among various

26. VAT deducted as input tax credit on one firm should show up in the VAT paid figures of the firm's suppliers, for example.

27. For complete economic optimality, the rate should not be uniform, but be higher on commodities with inelastic demand and lower on those with elastic demand. But knowledge of demand elasticities is inadequate to permit the development of such rate schedules; rate variation is intolerable from an operational standpoint; and the proposal would violate usual equity standards, requiring higher rates on "necessities" than "luxuries."

families on the basis of consumer preferences, and, frequently, complicate compliance and administration because of the need to distinguish between taxable and nontaxable items and among sales at various rates.

b. It should apply only to consumption expenditures, and thus not to savings or to purchases for use in production. Taxation of savings or uses of savings would contradict the consumption intent of the tax. Taxation of production inputs has several undesirable consequences, including that of producing a haphazard and unknown final pattern of distribution of burden among various families.

2. The overall distribution of the burden of the tax structure as a whole must conform to accepted equity standards of the society.
3. Compliance and administration problems must be kept to a minimum to be consistent with effective collection.
4. The base of the tax—taxable transactions—must grow with the growth of the economy, but should be relatively stable over periods of change in business activity, in view of the obstacles in the way of state and local borrowing.

As will be discussed, it is obvious that these various criteria may conflict; the desire to gain greater equity may suggest certain exemptions—inconsistent with the universality criterion, for example—and administrative considerations may make it difficult to attain universality, equity, or other objectives. Where conflict does occur, compromise among the various objectives is necessary in an effort to gain overall optimality.

Continuing adjustments in sales tax structures occur as a result of changes in the structure of the economy and in the nature and practices of retailing; the pressure of various special interest groups; altered revenue needs; changes in the views of key legislators and governors; and findings emanating from occasional overall studies of the tax structure of a state, often commissioned by state legislatures. (These latter studies have been occurring for a century;[28] recent ones include those of Minnesota, Nebraska, Connecticut, and Iowa.)

## *VARIANTS OF STATE SALES TAXES*

Most of the state sales taxes are pure retail levies, in that they apply only to sales made at retail, that is, for use or consumption and not for resale. An exception is Hawaii, whose tax, developed in the 1930s independently of the other sales taxes, applies also to all sales in production and distribution, but at low rates at the nonretail level. Arizona includes a severance tax on mining and logging, and

28. One of the earliest state tax studies was the *Report of the Commission on Revenue and Taxation of the State of California* (Sacramento, Calif.: Superintendent of State Printing, 1906).

# SALES TAX STRUCTURES, MEASURES OF TAX LIABILITY, AND RATES

Most states modeled their sales taxes after the taxes of other states. There are, nevertheless, significant differences in structure. Legal liability varies, as do provisions on shifting, rates, coverage of nonretail sales, exemptions, and treatment of services. This chapter reviews the general structure of sales taxes, measures of tax liability, tax rates, and nonretail elements in the taxes. Chapters 3 through 5 cover other aspects of structure.

## *STANDARDS FOR EVALUATING SALES TAX STRUCTURES*

To evaluate various features of sales taxation, standards must be established based on consensus in contemporary society. The following standards appear to be widely accepted:

1. The sales tax is designed to be a uniform tax on consumer expenditures, except where there is specific justification for exception. Its structure, therefore, should (a) facilitate shifting the tax to the ultimate consumer, (b) apply to all consumption expenditures at a uniform rate, except in circumstances in which deviation from this rule has specific justification, and (c) apply to the amounts actually paid by final consumers.[1]

1. The rule that sales taxes should be uniform on all consumption expenditures has been questioned in recent years by the theory of optimal taxation, on the grounds of economic effects. The demand for some commodities is more elastic than the demand for others; to the extent that tax rates are higher on inelastic demand commodities and lower on elastic demand commodities, alteration of economic activity as a result of the tax will be minimized. Taxes should be heavy on commodities complementary to leisure and low on those complementary to work in order to avoid effects of substitution of leisure for work. There are two problems, however, in implementing such a system. First, elasticity of demand for various goods is not known with any high degree of accuracy, especially when all or most prices are changing. Second, this rule would conflict with usual standards of equity, since the demand for basic necessities is probably more inelastic than the demand for luxuries. Most of the optimal tax literature was stimulated by the papers of P. A. Diamond and J. Mirrlees, "Optimal Taxation and Public Production I: Production Efficiency; and II: Tax Rules," *American Economic Review* 61 (1971): 8–27, 261–78. For an easier treatment of the problem, see A. Sandmo, "Optimal Taxation—An Introduction to the Literature," *Journal of Public Economics* 6 (1976): 37–54.

2. As a component of the overall tax structure, the sales and use tax should be designed to minimize regressivity in the distribution of tax burden in order to conform as closely as possible to accepted standards of equity.
3. The tax structure should not create competitive disturbances among various types of distribution channels, methods of doing business, forms of business organization, and the like; otherwise, economic efficiency will be lost.
4. The tax structure should facilitate administration and vendor compliance.

## *VENDOR, CONSUMER, AND HYBRID TAXES*

Customarily, various state sales taxes have been classified into two neat packages: privilege taxes on the vendor and consumer taxes on the sale. Each has certain characteristics relating to shifting, compensation to vendors, requirements for separate quotation, and other features. Actually, careful examination of the taxes suggests that this classification is less than useful and is in fact misleading. A more satisfactory classification utilizes three groups: vendor taxes, consumer taxes, and hybrid taxes. Even with this approach, however, there is substantial nonuniformity of various features within each class. The most significant feature of the taxes is the uniformity with which they operate despite some differences in structure.

### Vendor Taxes

Taxes in 13 states are, at least by law, basically vendor levies. They are imposed on the legal basis of the ''privilege'' of engaging in business as a retailer or on the closely related concept of the ''privilege'' of selling at retail. This vendor-tax group consists of Arizona, California, Connecticut, Hawaii, Kentucky, Michigan, Nevada, New Mexico, North Dakota, South Carolina, South Dakota, Tennessee, and Wisconsin.

None of these states requires shifting of the tax to the consumer. Connecticut, Nevada, and Tennessee require shifting ''insofar as possible,'' a phrase having little significance except to make clear the legislative intent. Kentucky, Michigan, North Dakota, South Carolina, South Dakota, and Wisconsin indicate that the tax ''may'' be shifted. California allows but does not require shifting; whether tax is added to price depends on the terms of agreement of sale. Absorption is unlawful in Connecticut and North Dakota. Vendors in Michigan have a right to reimbursement but are not required to shift or quote separately. The laws in Arizona, Hawaii, and New Mexico, which provide the most strictly ''vendor'' taxes of all, do not mention shifting.

# TAX TREATMENT OF PRODUCTION INPUTS

As noted in chapter one, a retail sales tax should logically apply to all sales made for consumption use by the purchaser and exclude all sales of production inputs—purchases for use in production—unless there are compelling reasons to the contrary. Any exclusions from tax of transactions for consumption purposes—usually called exemptions—violate the principle of universality and can be justified only for strong reasons. Taxation of any production inputs can be warranted only if compliance and administrative considerations make taxation imperative. This rule of universality of taxing consumption transactions and complete exclusion of transactions in production inputs was not recognized in the earlier days of the sales tax, but has come to be accepted at least in degree—the trend to acceptance due in part to the worldwide use of value-added taxes, one of whose greatest merits is the ease of excluding production inputs from tax.

## *IMPORTANCE OF EXCLUDING PRODUCTION INPUTS FROM TAX*

There are several major reasons for excluding from tax all production inputs, so far as possible: First, taxes on production inputs will not constitute a uniform percentage of tax in relation to consumer expenditures on various goods, or deviate from uniformity in a desired pattern. Some goods require, for optimal efficiency in production, more dollars of taxed production inputs per dollar of selling price than other goods require. Families with relatively high preferences for those goods bearing more input tax in their prices will be discriminated against and will tend to shift to other goods. If some consumption goods are regarded as justifiable to exempt, they will bear some tax on their inputs.[1] This effect may be regarded as acceptable, if the service provided (e.g., banking) is difficult to tax since the customer is not directly charged.

A second reason for excluding production inputs from tax is that the tax on inputs will alter somewhat the choice of production methods, since inevitably

1. This effect is shown clearly in table IV-8 of a study of the Iowa Tax by Policy Economics Group, KPMG Peat Marwick, *A Study of the Iowa State and Local Tax System* (Washington, D.C.: author, 1993).

some methods attract more input tax per unit of output than others. Replacement of old equipment will be delayed if new equipment purchases incur tax. Some inputs, especially capital equipment, will be taxed more heavily than others, relative to the prices of consumer goods produced, thus altering production input patterns.[2]

Third, firms will be given an incentive to manufacture needed production inputs themselves, since tax will apply to the purchase of such goods but only to materials if the firms produce the goods.

Finally, producers in states that free fewer production inputs than other states will be placed at a competitive disadvantage relative to firms in states that tax a smaller portion of production inputs.[3] Almost all European countries, Canada, and most countries in Latin America and Southeast Asia have moved to the value-added form of sales tax, which in general excludes all production inputs from tax. This may be offset to a limited extent by shifts in foreign exchange rates, but in any event production efficiency will be lost.

## *OBSTACLES*

There are several obstacles in the path of eliminating all production inputs from the tax. First is the operational one, the problem for sellers of distinguishing between sales for consumption and sales for use as production inputs. Many commodities can be used for either purpose. The buyer, in fact, may not always know at the time of purchase what the use will be, and some goods may be used partly for each purpose: a farmer's pickup truck, for example.

A second obstacle is the very substantial amount of revenue that can be obtained by including at least some production inputs. A third obstacle has been the widespread failure to recognize the importance of excluding production inputs from tax.

Finally, there is a major political problem: voters and legislators frequently favor taxes that apply to "business" rather than to indiviudals as income earners or consumers, even though it may be rather obvious that taxes on purchases by business firms tend, at least in part, to be reflected in the costs of consumer goods. The exclusion is portrayed as a "break for business," "a way in which business gets away without paying its fair share."

2. David Joulfaian and James Mackie, "Sales Taxes, Investment, and the Tax Reform Act of 1986," *National Tax Journal* 45 (March 1992): 89–106.

3. It is reported that the Intel Corporation moved various activities out of California because of the taxation of production inputs.

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**On sales and use tax exemptions:**

"Any exemption of household consumption is suspect tax policy. Exemptions cause higher statutory rates, make compliance and administration more expensive, cause tax burden to vary according to household preferences, and make tax yield less stable. Of course the exemptions violate the fundamental logic of the sales tax as a tax on consumption."

"The intentions of reducing regressivity and of giving families a tax-free minimum can ber fore more easily provided in other parts of the revenue system -- with better targeting and less revenue lost to the g overnment. Exemptions are politically popular, but a broad-base, low-rate sales tax with social concerns handled elsewhere in the fiscal system makes the soundest public policy."

**On taxation of business inputs:**

"I think legislatures like the taxation of business inputs because these are 'taxes on business,' as opposed to 'taxes on individuals,' and because the eventual inclusion of the tax paid on business inputs in consumer prices makes the burden of the tax fully opaque. Despite the philosophical arguments for transparency and responsibility, both hidden taxes and taxes that appear to be paid by somebody else are politically popular. Furthermore, legislatures can selectively grant business purchase exemptions to favor certain economic activities. Objections that taxing business inputs discourages economic development, interferes with the free operation of the market, adds to the regressivity of the tax, and erodes uniformity of application of o the tax have had only limited influence on legislative action. . . . Stressing the developmental significance of exempting business purchases seems the most promising approach, but legislatures still like to limit exemptions to "good" business purchases, as if that has some real meaning."

Source:

State Tax Today, November 22, 1999. *Interview: John L. Mikesell on the Present and Future of the Sales Tax.* 1999 STT 224-21. (Release Date: November 16, 1999) (Doc 1999-37015 (5 original pages))

# Sales Tax Incentives for Economic Development: Why Shouldn't Production Exemptions Be General?

*Abstract* - *Principles of sales taxation hold that production input purchases should be exempt for efficiency and burden transparency. State legislative politics collides with principles. Rather than providing general exemption, states encourage economic development through special preferences for businesses making certain purchases, although some offer wider general production exemptions than others. States do not provide broad exemptions because lawmakers focus on taxing final sales of things without understanding the consumption base intent of the sales tax, because they like the political safety of hidden taxes and apparent avoidance of burden on individuals, and because they prefer taxes more likely to be borne by non–residents.*

## INTRODUCTION

One great puzzle of state tax policy is why broad exclusion of production inputs from the sales tax is so difficult to accomplish even as states aggressively seek economic development and expansion by reducing taxes paid by businesses. Full exclusion of all production inputs from state sales taxation is consistent with ideas of efficiency that should drive tax policy in a market economy and with ideas of transparency critical for good governance. No state meets the full exemption ideal and that opens the door—virtually requires that the door be opened—to special development incentives. Rather than pursuing the general exemption, state governments seek to encourage economic development by providing special sales tax incentives for certain businesses making certain purchases, although some states do have much wider general exemption of some classes of business purchases than do others. However, even these exemptions generally are stuck in the world of production of things—just as is the sales tax itself—leaving a system mismatched to much economic development. To sort through this array of differences in state sales tax bases, this paper examines the current status of production exemptions, discusses why even at the broadest they are now too narrow, and explores the reasons why doing right with the sales tax is so difficult.

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The failure to remove business purchases from sales taxation, either by exclusion or exemption, creates four major problems for growth and development.

1. The tax will influence the choice among methods of production because state tax treatment will not be neutral. In particular, there is a disincentive for replacement of old equipment with new, emerging both from taxation of the new and from exemption of certain repair costs, thus slowing embodiment of new technology in production processes and causing lost economic efficiency and unnecessarily high production costs.
2. Businesses will have an incentive to produce for their own use, rather than outsource, because own production entails tax only on materials purchased. Furthermore, they have incentive to design outsourcing contracts to exploit different sales tax treatment of materials and labor, thereby adding cost for tax saving only, not for any fundamental economic gain.
3. Businesses will be at economic disadvantage in competition with states providing broader producer input exemption and, of increasing significance, in competition on world markets with entities producing in VAT countries that afford more complete exclusion of producer purchases. Embedded tax paid on production inputs will make the product relatively more costly in these comparisons.
4. Because states do have some idea of the development impact but are not willing to provide broad exemption, they provide special and narrow exemptions. Unfortunately, the process itself adds to compliance cost for enterprises, making the cost saving and development advantage less than it should be, and the advantage of exemption falls on only selected enterprises.

Furthermore, the tax loses transparency because the easily seen statutory rate does not reflect the effective burden of the tax and some stability because the base includes more volatile producer durable good purchases.

The ultimate strategy for market–oriented economic development is, of course, to follow the consumption tax model for sales tax design outlined years ago:

> "If a sales tax is to be a truly general consumption tax, it should apply to all expenditures for personal consumption purposes but not to any transactions involving use in business activity . . . Inclusion of purchases for production purposes is contrary to the philosophy of the tax, results in haphazard and uncertain distribution of the tax burden, affects choice of production process, and, from a state's standpoint, may adversely affect economic development"(Due, 1982; p. 200).

However, the practice of American retail sales taxes is to continue the "final sale of things" model of the first Depression–era taxes. No state has ever been as liberal as the European–style subtraction value added taxes in removing inputs from tax and none closely approaches the household–consumption–only ideal. States do generally exclude sales for resale and sales of materials that become physical ingredients of goods produced for resale by the purchaser.[1] This reflects the "tax things once" philosophy. It does not reflect the understanding that taxing other inputs to production has similar consequences. The

[1] The exemption of materials is an extension of the resale exemption—in the tax logic, the materials, when becoming part of the item, are resold as that item. This logic isn't extended to other purchases.

problem is not that of taxing a particular physical item twice, but rather that of taxing inputs, embedding the tax in production cost, and then taxing the product again with the same tax. Unfortunately, the resale and ingredients exemption is about as far as some states go as a matter of basic sales tax law. Even the broadest business purchase exemption still leaves a considerable share of inputs in the sales tax.

## AN INVENTORY OF STATE SALES TAX TREATMENT OF BUSINESS PURCHASES

The sales taxes emphasize taxation of tangible personal property, not services, in their coverage and concentrate on manufacturing and distribution of those physical products in its anti–cascading mechanism. Their progress toward including household services in the base has been glacial, as has been extension of business purchase exemption to the service sector; businesses in that sector make sales without collecting tax, but they also pay tax on the things they purchase. By accident, service sector and new economy businesses are badly treated in the exemption process because their operations are not of the "metal crunching—thing producing" variety that sales taxes were built around. As a result, sales tax structures discourage economic development, particularly in the non–manufacturing, non–processing sectors of the economy. Even as states slowly expand exemption to more business purchases of things, they continue to be behind the changing nature of the economy.

The tax laws view many business purchases as final consumption and, hence, tax them. That yields more revenue from any given statutory tax rate, although it causes the effective rate on the final product sold to households to be higher than the advertised rate because of embedded tax paid by producers on their purchases. The problem is that the tax, while hidden to consumers, is apparent to businesses—and that creates the distortion and development disincentive.

Purchases by business—none of which should be subject to sales taxation if the tax intends a uniform distribution of the cost of government across consumers—can be divided into three broad general categories for analysis of tax treatment: purchases of operating inputs, purchases of machinery and equipment, and purchases for construction of buildings and similar infrastructure. The pattern is for states to treat these categories differently, as a review of laws across the states clearly demonstrates. A summary overview of exempt status of these purchases appears as Table 1.

### *Purchases of Operating Inputs*

Sales tax treatment of inputs for current operations generally follows the idea that a purchase for resale is not a retail purchase. All states do exempt purchases of inventory for resale—although Hawaii does levy a low rate wholesale tax as one element of its General Excise Tax. States are almost as generous in their exemption of raw materials that become physical ingredients or component parts of goods to be sold or that are elements of processing or fabrication—only Connecticut and Hawaii tax them, both at lower than standard rates.

When those raw materials are used or consumed in research and development, however, the general pattern of exemption deteriorates. The majority of the states consider these purchases to be for consumption, not resale, and hence taxable. Only nine states—Arizona, Florida, Maryland, Massachusetts, Michigan, Minnesota, Pennsylvania, Vermont, and Virginia —exempt these raw material purchases, although a few other states do exempt under certain circumstances. For instance, California provides partial exemption for certain such purchases by start–up compa-

**TABLE 1**
**STATE SALES TAX PROVISIONS FOR FULL AND GENERAL EXEMPTION OF CATEGORIES OF BUSINESS PURCHASE**

| | Resale | Materials–Ingredients | Materials–Processing | Materials–Research | Electric | Gas | Water | Telecom Service–Intrastate | Telecom Service–Interstate | Internet Access | Software Custom | Mfg. Equip & Machinery | Pollution Control–Air | Pollution Control–Water |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Alabama | X | X | X | | X | X | X | | X | X | X | RR | X | X |
| Arizona | X | X | X | X | | | | | X | X | X | X | X | X |
| Arkansas | X | X | X | | | | | X | X | X | | N & E | F | F |
| California | X | X | X | * | X | X | X | | X | X | X | * | | |
| Colorado | X | X | X | | | | X | | X | X | X | X* | | |
| Connecticut | X | | X | | | | X | | | * | | X | X | X |
| Florida | X | X | X | X | | | X | | | X | X | N & E* | X* | X* |
| Georgia | X | X | X | | | | X | | X | X | X | X | X | X |
| Hawaii | RR | RR | RR | | X | X | X | | X | X | | | X | |
| Idaho | X | X | X | | X | X | X | | | X | X | X | F | F |
| Illinois | X | X | X | * | X | X | X | | | X | X | X | X | X |
| Indiana | X | X | X | | | | | | X | X | X | X | F | F |
| Iowa | X | X | X | | | | | | X | X | X | X | X | X |
| Kansas | X | X | X | | | | | | | X | X | X | | |
| Kentucky | X | X | X | | | | | | X | X | X | N & E | X | X |
| Louisiana | X | X | X | * | | | | RR | | X | | | X | X |
| Maine | X | X | X | * | | | | | X | X | X | X | X | X |
| Maryland | X | X | X | X | | | X | X | X | X | X | X | X | X |
| Massachusetts | X | X | X | X | | | X | | | X | X | X | | |
| Michigan | X | X | X | X | | | | | | X | | X | X | X |
| Minnesota | X | X | X | X | | | | | | X | X | | * | * |
| Mississippi | X | X | X | | | | | | RR | X | | RR | RR | RR |
| Missouri | X | X | X | * | | | | | X | X | X | X | X | X |
| Nebraska | X | X | X | | | | | | X | X | | | X | X |
| Nevada | X | X | X | | X | X | X | | | X | X | * | | |
| New Jersey | X | X | X | | X | X | X | | | X | X* | X | | |
| New Mexico | X | X | X | | | | | | | X* | X | * | | |
| New York | X | X | X | | | | X | | X | X | X | X | X | X |
| North Carolina | X | X | X | | | | X | | X | X | X | RR | RR | RR |
| North Dakota | X | X | X | | X | | X | | X | | X | N & E* | | |
| Ohio | X | X | X | | X | X | X | | | | X | X | X | X |
| Oklahoma | X | X | X | | | | X | | | X | X | X | | |
| Pennsylvania | X | X | X | X | | | X | | | X | X | X | X | X |
| Rhode Island | X | X | X | | | | | | | X | X | X | X | X |
| South Carolina | X | X | X | | | | X | | X | X | | X | X | X |
| South Dakota | X | X | X | | | | | | X | | | | | |

**TABLE 1** (continued)
STATE SALES TAX PROVISIONS FOR FULL AND GENERAL EXEMPTION OF CATEGORIES OF BUSINESS PURCHASE

| | Resale | Materials– Ingredients | Materials– Processing | Materials– Research | Electric | Gas | Water | Telecom Service– Intrastate | Telecom Service– Interstate | Internet Access | Software Custom | Mfg. Equip & Machinery | Pollution Control– Air | Pollution Control– Water |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Tennessee | X | X | X | | | | | | | | | X | X | X |
| Texas | X | X | X | | | | X | | | * | | X | X | X |
| Utah | X | X | X | | | | X | | X | X | X | X | X | X |
| Vermont | X | X | X | X | | | X | | | X | X | X | | |
| Virginia | X | X | X | X | X | X | X | X | X | X | X | X | X | X |
| Washington | X | X | X | | X | X | X | | | X | X | X | X | X |
| West Virginia | X | X | X | | X | X | X | X | X | X | | X | X | X |
| Wisconsin | X | X | X | | | | X | | X | | X | X | X | X |
| Wyoming | X | X | X | | | | | | | X | X | | | |
| DC | X | X | X | | | | | | X | X | | | | |

NOTES:
X: exemption provided.
RR: purchases are not exempt, but a reduced tax rate applies.
N&E: purchase exempt if made by new and expanding industry.
F: pollution control equipment exempt if required by federal law.

*Texas: first $25 per month is exempt.
*Connecticut: exempt after July 1, 2002.
*Florida: full exemption for repair and replacement equipment and machinery being phoned in.
*Nevada: deferral without interest for capital goods, purchases; exemption for approved purchases by newly–locating or expanding industries.
*California: partial exemption possible for certain start–up companies.
*New Mexico: interest access charges deductible from gross receipts.
*Florida: certain pollution control facilities and equipment exempt.
*Minnesota: pollution control equipment purchased by steel reprocessors or used at resource recovery facility may be exempt. Also, certain biosolids processing equipment.
*Oklahoma: exempt certain equipment.
*Colorado: purchases over $500 exempt.
*Illinois: manufacturers' purchase credit may be used for subsequent purchases of research and development property.
*Louisiana: rebates available for certain businesses in biomedical and university research and development parks.
*Maine: exemption for supplies used in biotechnicology applications.
*Missouri: exemption for research and experimentation by life science companies involved in research in agriculture, pharmaceuticals, biomedical or food ingredients. (statewide limit to annual total)
*New Jersey: also exempts custom software.

Sources:
Commerce Clearing House, *2000 State Tax Handbook*. Chicago: CCH, 1999.
Research Institute of America, *2001 All States Tax Handbook*. New York: RIA, 2001.
Research Institute of America, *2001 Guide to Sales and Use Taxes*. New York: RIA, 2001.

nies and Missouri exempts purchases for use or consumption directly or exclusively in research or experimentation performed by life science companies doing agricultural, pharmabiomedical, or food research.[2]

Sales tax laws provide much narrower exemption of inputs purchased that do not become an identifiable piece of the product being sold. This problem is apparent in treatment of water, electric, gas, and telecommunication utility purchases. Purchases of utilities—electric, gas, water, and telecommunications—by businesses do tend to be taxed by the states. These purchases, even though crucial to the operation of even manufacturing businesses, do not appear as a part of the product and the continuing focus on production of things erects a barrier against appropriate economic treatment. Water purchases are more frequently exempt than the other utility purchases—possibly because the link between water and the produced thing seems closer in the legislative mind, but 17 states fully tax water purchases. Exemption of electricity and gas purchases are considerably less frequent and those states that do exempt frequently limit the exemption to amounts of the utility being directly used in production; in other words, electricity purchases to drive the production line would be exempt, while electricity purchased to illuminate the factory would be taxed. A requirement for separate metering is not unusual. Telecommunication services are least likely of all the utility service group to be exempt —there is no conceivable link to a thing in a direct production line—except interstate service, where many states continue to exempt, possibly the result of legislative inertia from prior fears that such coverage would be unconstitutional. These distinctions are consistent with the commodity and manufacturing emphasis of sales taxation, but not consistent with undistorted economic development.

The general pattern of exemption of operating inputs follows the product resale idea. The closer to identifiable physical inclusion, the more likely is exemption.

### *Purchases of Machinery and Equipment*

Businesses purchase many types of machinery and equipment. Some is directly used in manufacturing, but much is used in operation of the business at considerable remove from the product and none appears as an ingredient or part of the product and none is appreciably worn-out or consumed in production of a particular item. Furthermore, many businesses do not engage in product manufacture as their primary economic activity. These latter businesses will virtually always be consumers of final product as far as the sales tax exemption process is concerned.

How these purchases get treated differs by type of equipment. No state exempts business purchases of office furniture and equipment. For some business types, particularly in some service sectors, these purchases constitute an important element of total production cost, but they will be nevertheless taxed. Display and similar equipment typically are categorized with furniture and, accordingly, taxed—even though they are critical for normal operation of some businesses. They do not show up as part of the product sold, so they must be taxed. Treatment of equipment and machinery used in manufacturing is frequently exempt if it is in the direct production line. A few other states provide exemption for manufacturing machinery and equipment purchased by a new or expanding business.[3] The re-

[2] The Missouri program is limited to $1.3 million per year and is provided from August 28, 1999 through June 29, 2003.

[3] In 2001 legislation (S.B. 2352), North Dakota extended exemption to computer and telecommunication equipment for new or expanding businesses, by expanding the manufacturing concept to include companies creating computer software.

maining states tax these purchases as if they were sales made to a consuming household; the idea of the sales tax as tax on things, not general consumption, carries the day. That means that businesses not engaged in the manufacture of things are treated as household consumers and pay tax on these input purchases.

### *Purchases for Building Construction and Other Infrastructure*

When contractors purchase materials, these purchases are almost universally taxed under the sales tax. Contractors are excluded from registration requirement, they pay tax on materials they purchase, and do not collect tax on their construction contracts. This treatment—primarily an accommodation to private housing—means that business purchases of buildings and other infrastructure, including that used to accommodate production facilities, will bear an embedded sales tax and that these costs will be higher because of the tax. There are exceptions that cause contracts for business to be taxable in some states (Arizona, South Dakota, Mississippi, Hawaii, New Mexico, and Texas), although not always will the tax apply to full contract price. These taxable contractors then usually can purchase materials without paying tax. Non–profit organizations in around one–third of the sales tax states are able to "pass through" their purchase exemption status to contractors (Mikesell, 1992; p. 124.).

The pattern is inconsistent with both principles of sales tax design and a desire for economic development. A number of states, recognizing the disincentive impact, have included contractor purchase exemption provisions in their enterprise zone preference packages. Not all states with enterprise zone programs include sales tax provisions, but 23 states (listed in Table 2) do provide a sales tax purchase preference (exemption, deferral, credit, or rebate) to relieve purchases of building materials for use in the zone. There are few enterprise zones in some states and many in others, so the importance of this exemption provision varies among the states. However, the provision does provide some relief from this developmental disincentive, even when it is limited in scope of availability. In some states that are otherwise frugal with exemption of equipment and machinery, purchases of these items for use in an enterprise zone are also exempt.[4]

### *The Overall Pattern*

Using the status data shown in Table 1, it is possible to identify the broadest and narrowest quartile in terms of exemption of business purchases. The states with fewest exempt business purchase categories include Mississippi, South Dakota, New Mexico, Wyoming, Arkansas, Connecticut, Hawaii, Kansas, Louisiana, Minnesota, and Tennessee; the states with the most include Virginia, West Virginia, Maryland, Washington, Illinois, Alabama, Utah, Pennsylvania, Ohio, New York, New Jersey, Georgia, and Arizona. The Mississippi River generally divides the groups, with the narrow exemption group mostly to the west and the broad exemption group mostly to the east (and particularly in the northeastern quadrant).

The difference between the groups in treatment of business purchases is distinct. While exemption of inventory for resale and materials purchased as ingredients or for use in processing is nearly universal, two states in the narrow exemption group (Connecticut and Hawaii) do not fully exempt all such purchases. The differences are greater in the other categories. For materials purchased for use in

[4] Sales by retailers in an enterprise zone are also partially exempt in New Jersey—a development incentive not related to the producer purchase exemptions.

TABLE 2
ENTERPRISE ZONE SALES TAX PREFERENCES

| | |
|---|---|
| Alabama | Exemption for construction materials for enterprise business. |
| Arizona | Exemption for construction, repair, etc.; contracts in military reuse zone for five years after zone established. |
| Colorado | Machinery or machine tools in excess of $500.00 for use in enterprise zone. |
| Connecticut | Machinery replacement parts sold to business in enterprise zone. |
| Florida | Refund of 97% of tax paid (to $10,000.00) on building materials to rehabilitate real property in enterprise zone and business property used in zone if 20% of employees live in enterprise zone; otherwise, limit is $5,000.00. Exempt 50% of electrical energy charges; full exemption if 20% of employees reside in zone. Also other credits and refunds. |
| Hawaii | Qualified enterprise zone business exempt for up to 7 years on proceeds from manufacturing, wholesale, or service operations. |
| Illinois | Exempt tangible personal property used or consumed in enterprise zone or by any high impact business (measured in employment impact) in manufacturing or assembly of product for wholesale or retail sale, in graphic arts production, or in operation of pollution control facilities. Credit or deduction for building materials for use in enterprise zone. |
| Iowa | Refunds for utility services, property, and contracting services purchased in connection with facility located in economic development area. |
| Kansas | Exempt property or services for constructing, remodeling, etc., qualified business facility in enterprise zone; sale and installation of machinery and equipment for such facility. |
| Kentucky | Exempt building materials, equipment purchased by qualified businesses for use in enterprise zone. |
| Louisiana | Rebate building materials, equipment for businesses in enterprise zone. |
| Michigan | Exempt property purchased for use in qualified business activity (new facility or new business) in enterprise zone. Exempt tangible personal property used in high technology businesses relocating to a central city. |
| Minnesota | Exempt construction materials or equipment for use in border city enterprise zone (Commission of Trade and Economic Development option). |
| Mississippi | Exempt building materials and machinery and equipment to be used in enterprise zone or sold to company transferring national or regional headquarters into state. Also, similar exemption for business start–ups in less developed areas. Exempt all purchases for bond–financed Mississippi Small Enterprise Development Finance Act. |
| Nebraska | Refund for tax paid by businesses increasing employment and investing in state; higher refunds if located in enterprise zone. |
| New Jersey | Exempt construction materials for building, repairing, etc., for qualified businesses in enterprise zone. Exempt sales to businesses except for motor vehicles and energy) for use in enterprise zone. Exempt half of retail sales (some exceptions) by vendors in enterprise zone. |
| New Mexico | Local government may designate enterprise zone and reduce tax within it. |
| New York | Refund or credit on construction, rehabilitation, etc. Material for use in enterprise zone. |
| North Carolina | Refund for eligible machinery and equipment purchased for use in enterprise tier one or tier two area. |
| Pennsylvania | Exempt sales to qualified businesses (except motor vehicles) in Keystone Opportunity Zone, except property that will become permanent part of real property. |
| Texas | Refund tax on purchases of building materials, equipment, or machinery sold to enterprise project in enterprise zone (limit of $250,000.00 per year per project). |
| Virginia | Exempt purchases of qualified business firms for operations in enterprise zone; five year limit. |
| Washington | Deferral on purchases of materials and services used in construction of qualified buildings and machinery and equipment in designated distressed areas. |

Source: Same as Table 1.

research and development, four states in the broad exemption category provide full exemption, compared with one in the narrow group. For electricity and gas, the comparison is seven against one; for water, 12 against two; for intrastate telecommunications, three against one; for interstate telecommunications, eight against four; for internet access, 12 against nine; for standard computer software, one against zero; and for custom software, 12 against four. The differences are also considerable for production machinery and equipment purchases. For these purchases, 12 states provide exemption in the broad group, compared with three states in the narrow group; for air pollution control equipment, the comparison is 12 states against four, and for water pollution control equipment, the comparison is 12 against three.

In overall pattern, it is clear that there are substantial differences in how these groups of states treat purchases made by businesses. By comparing these two groups it is possible to gain some understanding of the barriers to production exemption across the states. In general, the latter group would overall exclude a greater share of producer inputs from their sales taxes than would the former.[5]

## BARRIERS TO BROADER PRODUCER EXEMPTION

Why are the exemptions not broader and more widespread? If some states manage broad exemption, why don't all the states and why do the broad exemption states not provide full exemption? There are several barriers that may have a role in preventing expanded exemption.[6]

First, many state lawmakers prefer taxes whose burden on individuals is concealed and whose application permits higher revenue without requiring a higher advertised or statutory tax rate. The tax applied to producer inputs passes both opacity and yield tests for political attractiveness. The burden of this component of a state sales tax is not apparent to the consuming public and applying the tax to producer purchases increases yield from any advertised rate. Here is the evidence on how the difference in producer exemption is used, based on a comparison of the narrow and broad exemption groups outlined above. The mean statutory rate in broad producer good exemption states is now 5 percent, compared with 5.5 percent for the narrow exemption states; slightly lower, as would be expected in the hidden tax strategy, but the difference is neither substantial nor statistically significant. In an environment in which great attention is given to advertised rates, this result is probably not surprising—states generally avoid levying obvious rates that differ dramatically from those of their neighbors. However, the sales tax base as a share of state personal income averages around 50 percent higher in the narrow

[5] Ring (1999) has estimated the share of state sales tax burden paid by consumers and, by implication, by producers across the sales tax states. In any state, the share depends on both the nature of the state economy and the legal structure of the state. The categorization here describes purely the latter, but is reflected in the Ring estimates: the mean producer share for the narrow exemption group is 44.2 percent, compared with 35.1 percent for the broader exemption group. This result is consistent with the estimates of actual distribution prepared by Ring.

[6] Some argue that taxation of business purchases operates as a substitute for taxation of services— tax is paid when the business purchases its inputs, so the business need not collect when it makes its sales. This intention is not reflected in the behavior of the broad and narrow producer purchase exemption groups: among the 11 states with narrow exemption are the three states with broadest coverage of services (South Dakota, New Mexico, and Hawaii) and only three with virtually no taxation of services (Wyoming, Louisiana, and Tennessee), while among the 13 states with broad exemption are six states with virtually no taxation of services (Virginia, Maryland, Illinois, Alabama, New Jersey, and Georgia). But even if there were evidence of taxing input purchases as a substitute for taxing service sales, this practice would certainly not justify taxation of purchases made by sellers of taxed goods.

exemption states than in the broad exemption states.[7] After allowance for differences in consumer purchase exemption—the broad exemption states generally exempt grocery food purchases, while the narrow exemption states generally do not—the narrow exemption bases remain about 25 percent higher, so that translates into much more revenue from any advertised rates that is raised in a way that is almost invisible to consumers / voters. This permits much greater sales tax reliance in the narrow exemption states: the average share of state tax revenue raised from the sales tax is 41.2 percent for states with narrow producer good exemption, compared with 31.8 percent for those with broad exemption.

Second, state lawmakers play the myth of taxes on business versus taxes on individuals to its greatest political advantage. Any expansion of business exemption—even when provisions make abundant sense in the logic of the sales tax—appears to favor business and to be contrary to the interest of individuals. Politically, it becomes difficult to reduce the tax on producer input purchases. The results are a demand for pairing reasonable narrowing of the impact on business with less reasonable narrowing of the impact on individuals and an inclination to provide producer purchase exemptions narrowly constrained to certain designated economic development. The latter inclination is illustrated by the enterprise zone provisions noted earlier and by statutes that exempt purchases by businesses only in certain industries (for example, purchases used directly in commercial motion picture production in Pennsylvania, Pa. Code 61–32–38). General provisions would be attacked as being unwarranted breaks for business, making them difficult for lawmakers to push. Even business lobbyists are inclined to seek narrow exemptions with stories linked to specific economic development than to seek general exemption. The political dynamic built on the impact–focused difference between taxes on businesses and taxes on individuals is a difficult one to overcome.

Third, state lawmakers generally prefer taxes that appear to be paid by nonresidents. Indeed, part of the business against individual balancing involves the export objective—the business share is presumed to be more likely to be exported than is the individual share. If a portion of the state sales tax gets embedded in prices charged for products that are sold out of state, the tax will be borne by outsiders (non–voters). Of course there is a problem if product prices are set in competitive national (or international) markets. Producers facing higher–than–normal embedded sales tax burden will need to absorb the tax in order to meet market prices, at which point the incentive to export collides with the desire for economic development. This is seldom noted in the general desire to constrain local taxpayer burden by avoiding the business purchase exemption.

Finally, state lawmakers show considerable confusion about the objective of general sales taxation. State tax expenditure budgets that are designed to show the revenue lost by special preference provisions typically include sales tax revenue "lost" from the exemption of sales of property purchased for use or consumption in the manufacturing process—some even include tax lost by the resale exemption. Without acceptance or understanding of the concept of the sales tax as an indirect general consumption tax, all transaction exemptions seem doubtful and forthright producer purchase exemption to perfect the tax base becomes exceedingly difficult. Business purchases make no more sense to include in the retail sales tax than would excluding business profit from an income tax. That concept is not widely understood by state lawmakers, however.

[7] The estimates are based on data in Mikesell (2000).

## CONCLUSION

Why shouldn't producer goods exemptions be general and why are producers' inputs so difficult to exempt? Because the sales taxes focus on taxing final sales of tangible personal property without a clear legislative view of the intent of a retail sales tax, because state lawmakers like the political safety of hidden taxes and apparent avoidance of levying a tax on individuals, and because lawmakers prefer taxes whose burden appears to be borne by non-residents. These motives combine to reduce the prospects for broad reform, inducing states to arrange narrow and targeted incentives for development in an effort to outguess market fundamentals and to produce apparently identifiable accomplishments for elected officials. Rather than applaud these targeted exemptions, however, we should recognize them as an index of the basic failure of the state's sales tax system and an indicator of how badly the state requires a fundamental restructuring of its tax.

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**ABSTRACT:** Charles E. McLure of the Hoover Institution, Stanford University, considers the characterisctics needed for a modern sales tax, all of which state sales taxes lack.

**SUMMARY:** Charles E. McLure of the Hoover Institution, Stanford University, considers the characterisctics needed for a modern sales tax, all of which state sales taxes lack.

A sales tax should provide taxation of all consumption, exemption of business purchases, exemption of investments, simplicity, and taxation by the state of destination, McLure says.

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by Charles E. McLure Jr.

## Introduction

[1] The retail sales taxes (RSTs) employed by most of the states suffer from obvious defects. In this they differ substantially from the value added taxes (VATs) used in the European Union. The differences can probably be explained in large part by historical accident; the sales tax was first introduced during the 1930s, well before the effects of taxation were understood as well as now and well before the VAT mechanism was invented. /1/ By comparison, the European VAT is a product of the 1960s.

[2] Economists have long understood the defects of the sales tax, but no one else much cared. The advent of electronic commerce is emphasizing the defects and may lead to pressure for reform. I hope that reform will not stop with elimination of only some of the defects -- that it will bring the sales tax into the digital age.

[3] I begin by describing the characteristics of a modern sales tax and then note how the state sales taxes differ from the ideal. I indicate how the VAT implements the modern sales tax and how the RST could be reformed to achieve the same result. Then I discuss in greater detail the need for simplification of the sales taxes. /2/

## A Modern Sales Tax

[4] A modern sales tax would have several characteristics, all of which the state sales taxes lack.

[5] Taxation of all consumption. A modern tax would apply uniformly to all consumption; it would not exempt certain products. That way, it would not distort consumer choices of what to buy or discriminate among consumers based on their preferences for taxed and exempt products. Perhaps as important, it would not be necessary for taxpayers and tax administrators to make sometimes "indistinct distinctions" between taxed and exempt products.

[6] Exemption of all business purchases. A modern tax would not apply to sales to other businesses. That way it would not distort decisions on the choice of business inputs or encourage vertical integration or tax-motivated "self-production."

[7] Exemption of investment. A modern sales tax would not be levied on investment; it would apply only to consumption. That way it would not discourage saving and investment.

[8] Taxation by the state of destination. A modern tax would be levied by the state of destination of products. Thus, under the destination principle, imports, from either other states or abroad, would be subject to the same tax as local products, and exports destined for other states or nations would not be taxed.

[9] Destination-based taxation has several advantages. First, it is more likely to reflect the provision of services to households than is taxation by the state of origin. Second, origin-based taxation is likely to distort the location of economic activity unless it is levied at a uniform rate across the country -- an undesirable restriction that would severely hamper the exercise of state fiscal sovereignty -- and it could lead to an unhealthy "race to the bottom" (low rates) as states compete for business. Third, origin-based taxation could lead taxpayers to manipulate transfer prices to attribute value to the states with the lowest tax rates.

[10] Simplicity. A modern sales tax would be simple -- or at least as simple as possible, given administrative realities and other important objectives. Simplicity has both intrastate dimensions -- those experienced by firms that operate only within a single state -- and interstate dimensions -- those experienced only (or primarily) by firms that operate in more than one state. The system would be stable and there would be no indistinct distinctions that distort choices and require taxpayers and tax administrators to exercise the judgment of Solomon. Tax systems would be

similar across states, except for differences in rates, so taxpayers operating in more than one state could comply with their obligations relatively easily. (Note that uniform rates are not part of the ideal system, as discretion over rates is required for the exercise of fiscal sovereignty.)

### Departures From the Ideal

[11] The extant state sales taxes depart from the ideal described above in important ways.

[12] Exemption of services. Rather than applying uniformly to all consumption, almost all state sales taxes exempt many products, chief among them services. Thus, for example, the purchase of a canoe may be taxable, but the rental of the same canoe may not be.

[13] Taxation of business purchases. Many business purchases are subject to tax, the primary exception being the purchase of products for resale.

[14] Taxation of investment. Capital goods are among the products that may be subject to tax in some states.

[15] Taxation at origin/failure to tax at destination. Extant state sales taxes violate the destination principle in at least two avoidable ways. /3/ Because of the taxation of business purchases, there is an important element of origin-based taxation in all state sales taxes. Because of the complexity of the sales tax "system" (see below), the Supreme Court has ruled that vendors that lack a physical presence in a state cannot be required to collect use tax for the state. Thus, imports may be taxed more favorably than local products, with obvious adverse implications for both equity and economic neutrality.

[16] Complexity. The complexity of the state sales tax is legendary. Even if we ignore intrastate complexity, the complexity is unacceptable. (Strictly speaking, the complexity that occurs because local jurisdictions levy surcharges on the state tax may appear to be an intrastate problem. In fact, it may be more problematic for interstate vendors.) The complexity that a business faces if it operates in more than one state includes the following: different definitions of the tax base (which products are subject to tax); differences in definitions of particular products (so that seemingly identical tax bases may be different); and different administrative requirements and procedures (registration, filing, payment of tax, audit, appeals, etc.).

### The VAT: A Modern Tax

[17] The value added tax employed by the members of the European Union comes fairly close to achieving the ideals for a modern sales tax just described. It is thus worthwhile to describe briefly how the VAT works, to establish a benchmark against which to appraise the state sales taxes. (Note that I am not suggesting that the states should adopt the VAT, as has sometimes been alleged. I reject that policy because of the difficulty of implementing local surcharges on a state VAT. See McLure, 2000b.)

[18] The VAT applies equally to goods and services, thereby satisfying the criterion that all consumption be taxed. Registered businesses are allowed to deduct VAT paid on their purchases from tax due on their sales. Thus, tax is collected only on sales to consumers. A zero-rate is applied to exports; because credit (and refunds, where credits exceed tax due on sales) is allowed for tax on business purchases, exports occur tax-free, as is required by the destination principle. Finally, the same tax is applied to imports as to locally produced goods. While few would characterize the VAT as a simple tax, at least all members of the EU follow many similar or identical rules, including those pertaining to the treatment of trade between them.

### A Modern RST

[19] It would be possible to achieve the same effects as under a VAT using the more familiar technique of the retail sales tax. First, all sales to business should be exempt, whether they be goods for resale, investment goods, office

supplies, or whatever. In administering this rule, state tax administrators could rely on the federal income tax rules: any expenditure that is eligible for a federal tax deduction would be exempt from state sales tax. /4/ Second, all purchases by consumers should be taxed; in particular, services should not be exempt. If there are to be exemptions, they should be limited in scope (e.g., for prescription medicines). Third, the system should be vastly simplified, by making it more uniform across states; I return to this topic below. Fourth, assuming enough simplification to make an expanded duty to collect reasonable, the physical presence test of nexus should be replaced with a test based on the quantity of sales made into a state.

Can We Achieve the Ideal by the Back Door?

[20] The defects of the present sales taxes combine in ways that produce results that may not be as bad as they sometimes may appear. For example, if those who sell exempt goods and services pay tax on their purchases, the exempt product is not truly tax-free. Also, overtaxation is not as bad as it may appear, because of the exemption of services, as well as the exemption of goods for resale, those physically incorporated in taxable products, etc. The question, then, is whether we should worry about departures from the ideal.

[21] I believe we should worry about the departures. It is virtually inconceivable that a hodgepodge of exemptions and overtaxation could produce results that are as fair and neutral as a system that is designed according to tax principles. Particularly worrisome is the fact that business inputs purchased from local vendors may be subject to tax, while those bought from remote vendors that lack nexus would be exempt. Perhaps more important, a system that taxes all consump- tion, exempts all business purchases, and implements the destination principle systematically is virtually certain to be simpler, as well as more neutral, than one that draws the indistinct distinctions found in current law.

What Kind of Simplicity is Required?

[22] I have no illusions that I will convince enough governors and legislators of the need to tax all consumption and exempt all sales to business to create a groundswell of support for such thorough reform. I recognize that most of the interest lies in two interrelated areas -- gaining enough simplification that an expanded duty to collect use tax is not unreasonable. But what kind of simplification -- and how much of it -- is required?

[23] On this I hold quite radical views. I like to think of a small "dot.com" retailer located in San Jose, Calif. -- or any other city of your choice -- contemplating making sales in Austin, Tallahassee, Bangor, and Minneapolis. In the absence of a nexus rule such as that in Quill, it would be necessary to register in all four of these states, learn the tax base of each state (including any difference in the way the state defines particular products), take account of any local sales taxes, file tax returns in each, risk being audited by each, etc. This would be an overwhelming task, except for the existence of compliance software that handles some of the problems -- but not all of them. Of course, the software is not inexpensive, and the National Governors' Association (NGA) has proposed making the software available at public expense, under its "zero-cost" option.

[24] I do not believe that this is the right approach. Shifting some of the costs of compliance from the taxpayer to the public sector does not eliminate the costs; it merely hides them. I believe we should eliminate costs that are not necessary -- costs that do not buy us anything important. Thus, I advocate massive simplification.

[25] During the National Tax Association's project on taxation of electronic commerce, we investigated the possibility of creating a "menu" of products; each state could define its tax base by deciding to tax or exempt each product, but would be required to define the products in the same way. It appears that the NGA zero-option proposal incorporates this approach. My best "guesstimate" is that the menu might contain as many as 10,000 separate items. In theory, software could contain "look-up" tables that indicated whether each item is taxable or exempt in each of 46 states; after all, the table would have only 460,000 cells. /5/ But note that this is only the start of the problem. It would be necessary to have a menu that indicates how each of the items would be treated if bought for use in various industries; this would entail some multiple of 460,000 cells, since the tax treatment of many products would depend on

the buyer's industry -- and even on the use being made of a particular product by a buyer in a given industry. /6/

[26] Contrast the NTA/NGA approach with that in the ideal for a modern sales tax. There would be only two items in the menu for the latter because all sales to consumers would be taxed, all sales to business would be exempt, and the base would be the same in all states. A de minimis rule would eliminate the need to file where tax due would not be significant. (In such cases tax might be paid to the state of origin.)

## What to Do About Local Sales Taxes?

[27] The existence of local sales taxes is one of the biggest flies in the ointment when one attempts to formulate a modern sales tax. (I have argued elsewhere that it would be more rational for state and especially local governments to rely on income taxes, instead of sales taxes; because we are not designing a system from scratch, we must take the existence of local sales taxes as given. See McLure, 2000b.) Several alternatives seem possible. One is to rely on a "software solution" to get the right answer -- charging the correct tax on all remote sales and channeling the money to the right local jurisdictions. A second is to require that there be only one rate per state. If this means requiring that all local jurisdictions in a given state have the same sales tax rate, I believe it goes too far, in terms of lost fiscal sovereignty. By comparison, use of a single use tax rate might be acceptable. (Use of a blended rate, which would exceed the sales tax rate in some localities, would presumably require congressional approval.) Although it is not pretty, I would prefer this option, which, unlike the software solution, would work for catalog sales not charged to credit cards.

## Concluding Remarks

[28] We have the opportunity to reform the sales tax to bring it into the 21st century -- to create a modern sales tax, instead of merely tinkering with a basically defective tax. Thus, I urge the members of the MTC to "think big" -- not to be satisfied with just enough reform to get by.

[29] Remote sales should be taxed like local sales -- but only if there is substantial simplification. I encourage you to push for radical simplification, not a system that enshrines significant costs of compliance by shifting them to the public sector. My true desire is that you would share my desire to rationalize the tax base by taxing services and exempting sales to business.

## References

[30] McLure, Charles E. Jr. "Electronic Commerce and the Tax Assignment Problem: Preserving State Sovereignty in a Digital World." State Tax Notes, Apr 13, 1998, p. 1169; *98 STN 70-21*; or Doc 98-12061 (13 pages).

[31] McLure, Charles E. Jr. "The Taxation of Electronic Commerce: Background and Proposal," in Nicholas Imparato, editor, Public Policy and the Internet: Privacy, Taxes and Contracts (Stanford. Calif.: Hoover Institution Press, 2000): 49-113. (a)

[32] McLure, Charles E. Jr. "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the State Sales Tax or Discard It?" Brigham Young University Law Review 2000: 77-137. (b)

[33] McLure, Charles E. Jr. "Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness" forthcoming in the Journal of Law and Technology.

FOOTNOTES

/1/ Those who oppose taxation of electronic commerce often defend their position by calling the sales tax "a Depression-era tax," as though this description, intended to be pejorative, were enough to condemn the tax for use in the 21st century.

/2/ The ideas presented here are explained more fully in McLure (1998), (2000a), and (forthcoming), as well as literature cited there.

/3/ Another violation of the destination principle, that caused by cross-border shopping, is probably unavoidable, because it could be prevented only through unacceptable interference with commerce between states and localities.

/4/ I interpret "deduction" broadly to include depreciation and deductions for cost of goods sold. Exemption might be allowed for some expenditures that are not deductible, such as land.

/5/ Note, however, that it would be impossible to communicate this information in a printed catalog -- a necessity for those who want to pay for mail-order purchases by check or money order, instead of letting the vendor calculate the tax and bill their credit card.

/6/ There is also the need for a menu to define the tax treatment of products bought by tax-exempt organizations.

END OF FOOTNOTES

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